Balhoff & Williams, LLC

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October 28, 2008

By Electronic Filing

Marlene Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20054

Re: ***Developing a Unified Intercarrier Compensation Regime***
Proper Routing and Compensation for Termination of Telecommunications Traffic
CC Docket 01-92
Compensation for ISP-Bound Traffic
CC Docket No. 99-68
High-Cost Universal Service Support
WC Docket No. 05-337
Federal-State Joint Board on Universal Service
CC Docket No. 96-45

NOTICE OF EX PARTE

Dear Ms. Dortch:

On October 28, 2008, Frank Louthan of Raymond James and I participated in a teleconference with Scott Deutchman of Commissioner Copp's office.

The discussion was focused on potential investment community reactions to the proposed reform of intercarrier compensation and universal service funding. The comments are outlined in the slides attached to this letter.

Respectfully submitted,

s/*Michael J. Balhoff, CFA*

Michael J. Balhoff
Managing Partner
Balhoff & Williams, LLC

cc: Scott Deutchman

Inter

Michael J. Balhoff, CFA
Managing Partner

About Balhoff & Williams

Balhoff & Williams, LLC, is a specialized professional services organization focused on providing financial and regulatory advice regarding the communications and energy industries. The principals of the firm have more than thirty years of combined experience in advising investors, companies and policymakers on complex investment, transactional and policy issues. The principals of Balhoff & Williams have extensive experience serving the telecommunications industry, including RBOCs, independent incumbent LECs, competitive carriers, and wireless operators, with particular expertise related to rural telephone providers. Additionally, we specialize in energy and other utility services industries. Our firm offers an unparalleled combination of experience, credibility, strategic insight and access in a rapidly changing environment.

Michael J. Balhoff, CFA, *Managing Partner*

Michael J. Balhoff, CFA, is managing partner at Balhoff & Williams, LLC. Previously, Mr. Balhoff headed for 16 years the Telecommunications Equity Research Group at Legg Mason, and covered equities of incumbent local exchange carriers. Prior to joining Legg Mason in 1989, Mr. Balhoff held posts as a graduate and undergraduate professor. He has a doctorate in Canon Law and four master's degrees, including an M.B.A., concentration in finance, from the University of Maryland. A Chartered Financial Analyst and a member of the Baltimore Security Analysts Society, Mr. Balhoff has been named on six occasions as a *Wall Street Journal* All-Star Analyst for his recommendations on stocks in the Telecommunications industry. His coverage of telecom, and especially rural telecommunications, was named by *Institutional Investor* as the top telecommunications boutique in the country in 2003. He has also testified multiple times before congressional committees, is regularly a featured speaker at conferences for investors and policymakers, and is widely quoted in the media, including television, newspapers as well as communications and business journals.

Bradley P. Williams, Esq., *Partner*

Bradley P. Williams joined the firm as a principal in 2005 and was named partner in 2007. Previously, Mr. Williams was a member of the Strategic Planning & Business Development group at Lowe's Companies Inc., the Fortune 50 home improvement retailer. Prior to joining Lowe's, Mr. Williams worked with Mr. Balhoff in the award-winning Telecommunications Equity Research Group at Legg Mason, focusing on incumbent and rural local exchange carriers. Prior to joining Legg Mason, Mr. Williams was a co-founder of eSprocket / Beachfire, a venture-backed company that evolved into one of the pioneers in mediation technology solutions for the financial services sector. Previously, he served as a financial executive for a Washington, D.C.-based holding company that integrated, through acquisitions, a significant regional freight rail network. Brad began his career as an investment banker in First Union's Capital Markets Group. He has a BA in Economics from the University of North Carolina and a JD from the University of North Carolina School of Law.

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Purpose and Overview

- Purpose
  - Provide investor perspective regarding rural carriers and regulatory supports
  - Comment on the proposed reform of intercarrier compensation & USF from the point of view of a financial analyst
  - Highlight the serious financial risks to the rural model and to the financing sources of the carriers
- Industry challenges
- Indicative RLEC financial model
- Financial analyst's view of specific proposals affecting rural carriers
- Comment on current financial turmoil as the backdrop for reform proposals
- Financial markets and regulatory reform

Executive Summary

- *Intercarrier and USF reforms are needed—provided they are based on a sound understanding of financial realities, including the rural financial model and the investment required to support public policy*
- *The investment case in high-cost regions is premised on . . .*
  - *An understanding of what is occurring in the core fundamentals in rural regions where competition is unfolding*
  - *A stable system that directs and supports carriers dedicating capital to serve uneconomic regions (obligations supported by policy system)*
  - *Financially viable carriers—with access to capital—in high-cost regions; including the mid-size ILECs that serve approximately 75% of independent telco subscribers*
- *A sound reform should be based on a careful financial analysis since indicative RLEC financial model reveals that even a 10% reduction in revenues can result in cash flow and equity value declines of 40%, and the risk is that the stocks go well lower rapidly*
- *Without an ARM, reduced cash flows will almost certainly result in failed policy—lower network investment, harm to customers & communities; and without ARM, the COLR system may not be viable*
- *Regulators must signal that a reformed "system" is fair and stable, not arbitrary and politicized—supporting public policy obligations*
- *In current markets, reforms that reduce stability and predictability will precipitate an even more severe reaction to sources of capital in a way that is harmful to customers, policy, the system, and investors*

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RLEC Challenges

- Intercarrier and USF reforms are needed—provided they are based on a sound understanding of financial realities, including the rural financial model and the investment required to support public policy
- Core rural ILEC operations
  - Rural operations undergoing fundamental changes due to competition and technological change
  - Competition is centered in clustered communities where profitability is relatively higher
  - True high-cost customers are in the outlying regions where competitors are not targeting services; and no competition is likely to develop in those regions in the near future
  - Support in rural America remains fundamental in serving high-cost regions
  - Mid-size rural carriers (at least partially price-cap) provide approximately 75% of the service to the independent telephone customers in high-cost regions
- Investors remain important stakeholders who recognize . . .
  - Capital-intensive business requires access to appropriate mix of debt and equity
  - The core declining fundamentals in regions where competition is unfolding
  - The importance of a stable system that directs and supports carriers in dedicating capital to serve uneconomic regions

Intercarrier and USF reforms are needed—provided they are based on a sound understanding of financial realities, including the rural financial model and the investment required to support public policy.

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ILEC Financial Model

- Regulatory-determined revenues have meaningful effects on the RLEC model
  - The model at the right highlights the importance of switched access and universal service receipts
  - The current model is assumed to be generating approximately correct returns
- Reform must be based on a clear understanding of the model's sensitivities
  - If access/USF reform is to occur, it must be based on an economic assessment of the real costs to support high-cost regions, if those obligations are to remain policy goals
  - Pricing hikes, including subscriber line charges, are likely limited by competition and the rural customers' economic levels, meaning that assumptions about potential for increases must be assessed carefully
  - Access revenues (most recently, intrastate access) have been cost-based elements *and* regulated support mechanisms
  - If policy is unchanged regarding carriers of last resort in high-cost regions, an access recovery mechanism (ARM) should offset lost support—assuming that the legacy system approximated reasonable support
  - USF remains fundamental

Typical RLEC Revenue Composition

	% of Total Rev.
Local voice	40.0%
Long Distance	9.0%
Switched Access & USF	19.0%
Data	24.0%
Other	8.0%
Total Revenues	100.0%

Source: Balhoff & Williams, LLC; based on financials of a large multi-state carrier

Approximately 70% of RLEC revenue streams are regulatory-based, prompting investor concerns about signals in a reform; operating leverage becomes materially less favorable as these streams come under pressure.

If policy is unchanged regarding carriers of last resort in high-cost regions, an access recovery mechanism should offset lost support—assuming that the legacy system approximated reasonable support.

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ILEC Financial Model (cont.)

Indicative RLEC Financial Statement

		FY	Margin
Revenues	$	100	
Cash Operating Costs		47	
EBITDA		53	53.0%
D&A		16	
Operating Income		37	37.0%
Capital Expenditures		12	
Free Cash Flow (pre-Dividend)		25	25.0%
Dividends		15	
Payout Ratio		60%	
Valuation			
Enterprise Value			
EBITDA	$	53	
Median Mkt Multiple		5.7	
Implied Enterprise Value		299	
Equity Value			
Levered Free Cash Flow	$	25	
Median Mkt Multiple		5.6	
Implied Equity Value		140	

RLEC Financials with 10% Reduction in Revenue

		FY	Margin	% Change
Revenues	$	90		-10.0%
Cash Operating Costs		47		
EBITDA		43	47.8%	-18.9%
D&A		16		
Operating Income		27	30.0%	-27.0%
Capital Expenditures		12		
Free Cash Flow (pre-Dividend)		15	16.7%	-40.0%
Dividends		15		
Payout Ratio		100%		
Valuation				
Enterprise Value				
EBITDA	$	43		
Median Mkt Multiple		5.7		
Implied Enterprise Value		243		-18.9%
Equity Value				
Levered Free Cash Flow	$	15		
Median Mkt Multiple		5.6		
Implied Equity Value		84		-40.0%

Source: Balhoff & Williams, LLC; based on financials of a large multi-state carrier

A 10% reduction in revenues can result in cash flow and equity declines of 40%, with the potential for equity to fall farther.

- Sensitivities in RLEC financial model are reflected in parallel models above
- If policy reforms / other pressures on pricing result in a mere 10% loss of revenue . . .
  - High-fixed cost nature of business limits ability to manage cash expenses, resulting in 40% reduction in cash flows
  - Importantly, cash flow decline drives down implied equity value by *at least* 40% based on 10% revenue reduction
  - Probable additional decline in equity value (beyond 40%) due to investors' concerns about regulatory stability
- Situation exacerbated by the need for increasing levels of network investment
- Without competitive dividend yields, RLECs will have less access and higher-cost access to equity capital
- RLECs will be compelled to make capital decisions that affect customers

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Investors and Specific Proposals

- Investors have been willing to put capital to work in rural telecom markets
  - The investment case has been premised on predictable support mechanisms and operations, which lead to relatively stable returns on investment
  - Systemic change in support will create a fundamental reassessment by debt/equity investors
  - Rumored proposal could be disastrous from an investor point of view
- Potential framework for understanding reform issues in light of investor criteria
  - Investors assess their ability to predict returns in light of levels of cash flows—*reductions in cash flows will result in at least proportionate reductions in equity values*
  - Regulators' signals that the "system" is fair/stable rather than arbitrary/politicized
    - Proposals for a unified rate theoretically eliminate arbitrage—good for the entire industry
    - An ARM must be implemented to shift implicit support to USF—as the reality is that access contains support—to preserve customer welfare, policy goals, and viability of system ensuring public safety, economic welfare, social benefits
    - Unified rates based on average urban costs harms LECs serving higher-cost regions
    - Reform systems must be fair and properly vetted, and the FCC should not rush into solutions that are potentially very harmful to the system supporting high-cost regions or might create undue uncertainty lest the financial foundation for rural investment be put at risk
    - Rural carriers' proposals are widely accepted as reasonable and competitively fair
      - Need for ARM
      - Phantom Traffic adjustments
      - Unified access rate that lowers intrastate rates to a level higher than current interstate rates
      - USF in very high cost (potentially non-competitive) regions to aid broadband builds

Regulators must signal that the "system" is fair and stable rather than arbitrary and politicized.

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Potentially Dangerous Cycle

Lower Revenue

Lower EBITDA

Less capital available for network investment

Lower FCF

Higher cost of debt / lower Equity Valuation

Credit downgrade

Taking away revenue, particularly high margin subsidies, negatively impacts EBITDA and FCF at accelerating levels. In this scenario, the company's cost of debt increases after the likely credit ratings downgrade. This in turn lowers FCF even further, exacerbating the problem and lowering valuation even further, which places the carriers' customers at-risk.

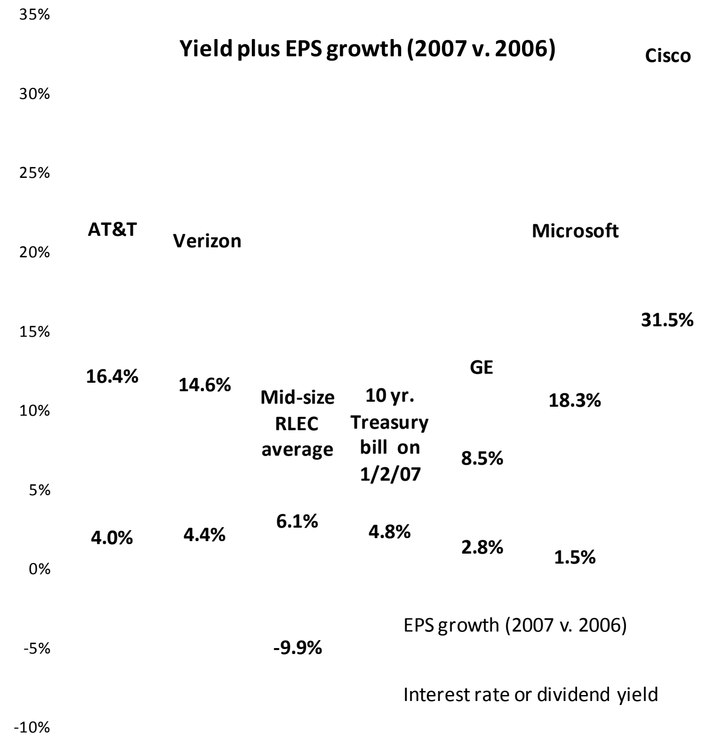
The result is less investment, which hurts consumers, lowers services levels, cause carriers to discontinue service, or all of the above

Dividends and Returns on Capital

		EPS growth 2007 v 2006 [1]	Projected dividend yield (Dec 31, 2006)	EPS growth plus expected yield 2007	Dividends total ($mils.)	Net share repurchases (issuances) ($mils.)
	AT&T	16.4%	4.0%	20.4%	$8,743	$8,404
	Verizon	14.6%	4.4%	19.0%	$4,773	$1,569
	Average	15.5%	4.2%	19.7%	$6,758	$4,987
[2]	CenturyTel	14.3%	0.6%	14.9%	$29	$411
	Citizens/Frontier	-17.7%	7.0%	-10.8%	$336	$236
[3]	Consolidated	NM	7.4%	NM	$45	$57
	Embarq	-14.8%	3.8%	-11.0%	$367	($109)
	FairPoint	-17.0%	8.4%	-8.6%	$56	$0
	Iowa Telecom	-14.2%	8.2%	-5.9%	$52	$0
[4]	Windstream	NM	7.0%	NM	$477	$40
	Average	-9.9%	6.1%	-4.3%		

[1] As reported by companies for 2007, and normalized to exclude extraordinary items.
[2] EPS in 2007 includes 8.7% increase due to 7.5% reduction in diluted shares outstanding in 2007 versus 2006.
[3] $0.47 v. a net loss of $0.83 per share.
[4] Not comparable due to acquisition and $415 mil. gain for sale of directory business; revenues grew 1.4%.

Source: Yahoo Finance; Balhoff & Williams, LLC



- Some have raised question about whether RLEC dividends are high and can be reduced—no!
- AT&T / Verizon equity values based on dividends *and* substantial operating growth
- A brief overview of EPS growth in 2007 v. 2006 (a proxy for capital appreciation) *plus* dividends provides an approximate view of comparative market requirements
- GE/MSFT/CSCO illustrate risk/return market characteristics that investors evaluate
- Even the U.S. government must pay for the use of capital in spite of very low risk
- Equity investors *require* dividends to supplement low/no capital appreciation
- The companies do not set required returns—the market does

Companies do not set required returns—the market does. Dividends are a component.

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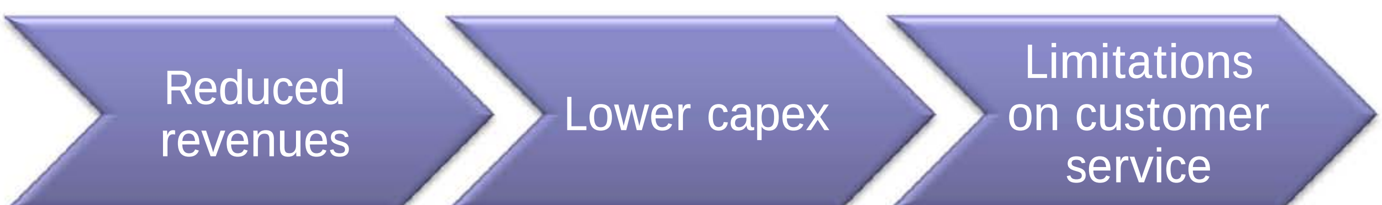
Capital Investment at Risk

- To be clear, significantly reduced revenues are likely to profoundly harm customers—whether because of lost access revenues or problematic rate increases in low-income regions
- If reforms are not grounded in an understanding of economic realities, the likely outcome is harm—potentially serious harm—to a century-old system that supports consumers and the networks that serve them
- If reforms result in material reductions to revenues, carriers will have to assess cash flow pressures in light of optional cuts to cash outflows, including . . .
  - Operating expense reductions –but these are difficult for high fixed-cost businesses
  - Dividend reductions—but cutting the competitive returns to investors puts at risk access to capital and eventually limits future capital investment
  - Capex reductions—economically rational carriers will not wish to choose to underinvest, but will recognize this as the most likely short or even long-term solution to cash flow shortages
- Unless the rural reform implements an appropriate ARM, the reality is that lower net revenues will put direct pressure on the carrier's ability to fund capital investment
- The predictable outcome is that the customer is directly affected by insufficient revenue generation and/or support, as the net result is reduced network investment



Without an appropriate ARM, the reality is that lower net revenues will put direct pressure on the carrier's ability to fund capital investment; and the predictable outcome is that the customer is directly affected by reduced network investment.

Current Financial Turmoil

- The current turmoil in the financial markets is complex and disturbing
  - Fundamentals are not driving the markets at the present
  - Fear has been the primary driver
  - Stocks have been decimated recently when there is uncertainty
  - The market's recovery is likely to be slow and cautious in light of the trauma
- Reforms proposed by the FCC regarding intercarrier compensation and USF are needed, as most observers concede
  - Carefully crafted reforms that signal a steady hand and clear policy will be welcomed
  - At the same time, the reforms MUST be demonstrably the right systems to generate a stable policy in support of a clear and sound set of system
  - If the reforms reflect a political—rather than financially-sound—accommodation, investors will react harshly to a perceived set of signals even in a stable market
  - In the current markets, a badly-formulated reform or one that signals uncertainty will almost certainly precipitate an outcome that is profoundly harmful to policy, the system, customers, and investors
  - The proposals must be broadly accepted, and based on a commitment to create a financially-sound stable policy system in support of customers in high-cost regions
  - Alternatively, reduced support should provide carriers with the opportunity to shed uneconomic obligations

If the reforms reflect a political accommodation, rather than one that is financially-sound, investors will react badly even in a stable market, but in the current markets, a badly formulated reform or one that signals uncertainty will almost certainly precipitate an outcome that is profoundly harmful to policy, the system, and investors.

Financial Markets and Reform

- Equitable and predictable treatment of all competitors is fundamental for investors
- Regulatory signals and supports are pillars of the investment case for rural carriers and for their customers
  - High-cost obligations must be offset by carefully calculated support—the two are inseparably joined for investors
  - Access (interstate and intrastate) is assumed to contain both cost factors and support factors
  - Access reform must explicitly address the support component for carriers serving high-cost customers
  - USF support compensates for mandated/regulated services to uneconomic regions
- Policymakers and consumers want widespread broadband deployment
  - RLECs face growing demand on their networks and a competitive need to invest in broadband
  - Core telecom industry fundamentals appear to be weakening
  - To provide a compelling case for investment in the broadband network of the future, the RLEC financial model must be stable, at a minimum
- In a capital intensive industry, regulatory solutions that ignore financial realities—the operating model and the financing requirements of capital providers—ultimately will do harm and potentially destroy the viability of the system serving public policy
- In the current environment, harm—intended or unintended—will be magnified and will occur rapidly

In a capital intensive industry, regulatory solutions that ignore financial realities and the needs of capital providers ultimately will do harm and potentially destroy the viability of the system serving public policy.